IN THE

Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 609

ELDORADO COAL AND MINING COMPANY,
Plaintiff in Error,

vs.

HARRY W. MAGER, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS,
Defendant in Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION.

PETITION FOR REHEARING.

To the Honorable Justices of the Supreme Court of the United States:

We respectfully petition for a rehearing in this cause.

This court, in its opinion in the case of *Merchants' Loan & Trust Company* v. *Smietanka,* No. 608, adopts a definition of "income," based on the view that the conversion of an increase of capital value into the severable form of cash realizes a gain, which, we respectfully submit, was never sug-

gested as a possible one prior to the adoption of the Sixteenth Amendment, and which is, as we shall point out, inconsistent with the regulations of the Treasury Department and specific provisions contained in the Revenue Act of 1918, passed in 1919. The first suggestion of such a definition is contained in the *Macomber* case, which was decided by this court one year after the Act of 1918 was passed, where it was stated that increases in value since the Sixteenth Amendment might be income if realized by a sale.

This court adheres to its decision that *mere* advance in the value of an investment is capital, but now holds for the first time that such advance in value is income within the meaning of the Sixteenth Amendment if severed, or rendered severable, by conversion into cash, and that income may be realized even if there be no voluntary conversion, as in the case of the bonds in the *Merchants' Loan & Trust Co.* case, No. 608, which were called and not sold. The rule established by this court prior to the adoption of the Sixteenth Amendment—that advance in the value of capital is not income but capital—is now qualified by the proviso, *except when converted, whether voluntarily or not, into the severable form of cash, in which case it thereupon becomes income and ceases to be capital.*

This court states in its opinion that an investor's sale of his investment for cash cannot be distinguished from a sale made by a merchant or trader in the course of his business. We respectfully submit, however, that this court in fact makes the same distinction between the merchant and the investor which we do. Selling for profit by a merchant or trader has no relation to increase in the value of the goods sold. In the case of the investor, however, this court holds that increase in value is the

fundamental consideration, and if the increase in value is converted into the severable form of cash, it is held to be taxable income, whether such conversion is the result of a sale or not. This court disagrees with our contention, therefore, only in holding that increase in value becomes income when separated or severed from the original value of the investment—it does not hold that there is no distinction between the situation of the merchant and the investor. In fact, it is necessary to distinguish between the merchant and the investor on the theory adopted by the court as well as upon the contention advanced by us, and for the same reason. Increase in money value, when realized in the severable form of cash, is made the sole ground for taxing the investor, but it is not the ground on which the merchant and trader are taxed. Increase in value is one thing, and profit on a sale is another, and this court distinguishes between the two and makes it necessary that such distinction should be determined as a question of fact.

The fundamental character of this distinction is made apparent by the situation which arises under the Income Tax Act of 1913. There was no provision in that act making March 1, 1913, values the basis for determining gains or losses in the case of subsequent sales. Merchants or traders, therefore, making sales after the effective date of that act were taxed upon the profits realized by such sales without reference to increases in the value of the goods sold, or to the time when such increases took place, if there were any.

This court, however, distinguishes the situation of the investor from that of the merchant in such a case. An investor who acquired his investment prior to the adoption of the Sixteenth Amendment and sold it in 1913, 1914 or 1915 would be taxable only on the increase in the

value of the investment occurring after the adoption of that amendment. (*Macomber* case, 252 U. S. at p. 212.) Increase in value is not only a material consideration in his case, but is the ground upon which his tax is based.

It is necessary under all of the income tax acts to distinguish between the merchant and the investor. The ground upon which the tax is assessed is not only different, but the deductions allowed and the method of estimating the tax is different under all of these statutes, and it is necessary, therefore, to determine as a question of fact whether the taxpayer is an investor or a merchant or trader. Indeed, until this fact is determined it is impossible properly to fill out the blank forms of return prescribed by the government, for these forms provide that income derived from sales of a merchant or trader is to be returned in one schedule and gains realized by sales of an investor in an entirely different schedule.

The merchant is not engaged in the business of converting increase in value into cash, and may realize his profit by an exchange of goods when no increase in value has occurred and there is no sale for cash. He is taxed on his profits on sales, and must continue to make sales to realize profits or discontinue business. The investor, in the view adopted by this court, is not taxed on profits on sales but on increases in value of capital when rendered severable by conversion into cash. He can avoid the tax by not converting his capital, or by converting it in such a way that the increase in value is no more severable afterwards than it was before the conversion. That there is a fundamental distinction between the merchant and investor is, therefore, recognized by this court as well as by the Treasury Department and ourselves.

What is now decided for the first time is that income is produced by changing capital into the severable form of cash where there has been an increase in the value of the investment. The first suggestion of such a holding that we have been able to find is contained in the opinion of this court in the *Macomber* case. Decisions of this court in cases arising under the Corporation Excise Tax Act of 1909 were rendered in cases of sales by corporations engaged in business, and the profits realized were included in the business profits due to corporate activities. The question whether every conversion of an increase in the value of an investment into the severable form of cash is a realization of income was not alluded to and was not in fact decided in those cases. Nor was it decided in the *Macomber* case.

We respectfully submit that this definition of income is not only new, but that it was not within the commonly understood meaning of that term which was in the minds of the people when they adopted the Sixteenth Amendment. If the trustee in the *Merchants' Loan & Trust Company* case had realized in 1916 that such a definition of income was a possible one it would have exchanged the stock there in question for other stock or securities no more severable in form than the stock which was converted into cash before being reinvested. It certainly did not realize that its option or powers of reinvestment under the trust were in any way enlarged by converting the stock in the first instance into cash, or that a gain was realized in that case which would not be realized by a direct exchange of securities. We are confident that the common understanding was the same.

This consideration leads to the ultimate question in this case—the settled meaning of the word "income" when the Sixteenth Amendment was adopted. That

amendment, while not technically a contract between the federal government and the states, involved an adoption by the states of the amendment as submitted by Congress. Prior to that time *Gray* v. *Darlington*, 15 Wall. 63, a decision of this court, had been cited in both state and federal courts in cases arising between life tenant and remaindermen as holding that advance in the value of an investment was not income but capital, even where the investment had been converted into the form of cash. See:

Devenney v. *Devenney*, 74 Oh. St. 96, 102.
Graham's Estate, 198 Pa. 216, 220.
Mercer v. *Buchanan*, 132 Fed. 501, 508.

Certainly these decisions are entitled to consideration in determining the common understanding of the meaning of the word "incomes" in the Sixteenth Amendment. It is a rule of this court, based upon fundamental considerations of justice and due process of law, that where a contract is made in reliance upon a decision of a state court and the state court subsequently changes its decision, this court will not follow the later decision of the state court and thus invalidate the contract.

Gelpcke v. *City of Dubuque*, 1 Wall. 175.

This case involves a situation where a decision of this court, *Gray* v. *Darlington*, has been cited and relied on by state and federal courts, prior to the adoption of the Sixteenth Amendment, as holding that increase in the value of an investment is not income, whether the investment be sold or not. The question now presented to this court for the first time, in this and other cases, is whether the word "incomes" as used in the Sixteenth Amendment shall be interpreted in accordance with that understanding. We respectfully submit that the due administration of law, as recognized by this court, requires

that the decision of that question shall be based upon decisions rendered prior to rather than since the adoption of the Sixteenth Amendment.

That the definition of the word "income" now adopted by this court is a new one is further evidenced by the fact that it is not in harmony with the present rulings of the Treasury Department nor with specific provisions contained in the Revenue Act of 1918. After the passage of the Income Tax Act of 1916 the department changed its mind about the taxation of increases in value of capital when there was an exchange of investments. Originally it had ruled that such exchanges did not realize a gain which could be taxed as income. Since that time it has ruled that income may arise in the case of what are called "closed" transactions, or under other circumstances not yet definitely defined by the department. In other words, the department claims a tax even where nothing has happened which renders the increase in value of an investment severable from the original cost or value of the investment, and does not recognize the qualification as to severability contained in the definition now adopted by this court. (See Brief for Plaintiff in Error, p. 53.) There are also specific provisions (Section 202 (b)) in the Act of 1918 which do not recognize this qualification. They read (40 Stat. 1060) as follows:

> "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking

the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged."

It is clear that the phrase "realized gain" is a new term which is itself in need of definition. Even if the qualification of this court as to the severability of the advance in capital value be applied (and the department has not as yet indicated any intention of applying it), it is still uncertain when such severability occurs. If two neighbors exchange houses which have increased in value it is obvious that the increment in value has not been rendered severable. But suppose one house is worth $10,000 more than the other and that that amount of cash is paid on the exchange. What does the $10,000 represent? An almost infinite number of variations of this puzzle will certainly arise, and the meaning of the term "realized gain" must depend entirely upon its future definition by this court. To adopt either the view of the department or of this court means that the word "incomes" in the Sixteenth Amendment is as yet undefined.

We respectfully submit, therefore, that the definition of "income" now adopted by this court is not only inconsistent with the common understanding of the meaning of that term, but is inconsistent with the settled meaning of that term as defined by this and other courts

prior to the adoption of the Sixteenth Amendment, and redefines "income" by using another term, "realized gain," which is itself uncertain and undefined.

Respectfully submitted,

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I hereby certify that in my opinion the foregoing petition for rehearing is well founded in point of law.

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